

ST 03-0019-PLR 08/25/2003 SERVICE OCCUPATION TAX

Sellers of special order machines are considered to be engaged primarily in a service occupation, rather than being engaged in the business of selling tangible personal property, if the test set out in 86 Ill. Adm. Code 130.2115(b)(1) is met. See 86 Ill. Adm. Code 130.2115. (This is a PLR.)

August 25, 2003

Dear Xxxxx:

This Private Letter Ruling, issued pursuant to 2 Ill. Adm. Code 1200 (which can be found at <http://www.revenue.state.il.us/LegalInformation/regs/part1200/>), is in response to your letter of January 24, 2003 and April 24, 2003. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to AAA for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither AAA nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

In your letter, you have stated and made inquiry as follows:

I am writing to you requesting a Private Letter Ruling (PLR), pursuant to 2 Ill. Admin. Code Sec. 1200.110, addressing the sales and use taxability of a specially-designed automated storage and retrieval system (the conveyors) which our client has purchased. PLRs respond to inquiries made by taxpayers or their representatives under power of attorney (attached). Further, we understand that PLRs discuss tax principals or applications and are binding on the Illinois Department of Revenue (the IDOR) to the extent that the material facts of the situation remain the same, and the law relied upon in the ruling does not change.

FACTS

AAA is a distributor of steel products (product). To streamline its inventory operations and achieve cost efficiencies, it contracted with another business (the Seller) to design and install four specially-designed and automated conveyors for use at its CITY, Illinois distribution facility (the warehouse). AAA uses the conveyors to account for and hold inventory. The conveyors fulfill customers' orders by retrieving inventory and packaging products for delivery. The conveyors are operated entirely through a computer system which the Seller has also provided to AAA. AAA originally had two of the conveyors engineered to conform to the particular size and shape of its existing warehouse. When AAA had a contractor build an addition onto the warehouse, it ordered from the Seller two additional conveyors. These were then designed and engineered to conform to the particular size and shape of the new addition.

To meet all of the aforementioned requirements, AAA chose the Seller over other businesses because of the Seller's reputation in the industry as a 'world-wide leader' in

its field. The Seller's website and its other promotional materials indicate that it considers itself an internationally-known market leader in engineering, designing, and manufacturing material-handling systems for meeting its customers' specific needs.

Each of the four conveyors was erected in sections of the warehouse known as bays. In designing and fabricating the conveyors, the Seller performed time-study simulations for determining their most efficient placement within each bay. The Seller performed the simulations using Company-supplied data relative to variances in its current and potential inventory levels, products' weights, shapes, and sizes, picks per hour, and storage and delivery requirements. The Seller's computer programs then generated layouts and designs specifically tailored to meet AAA's current and future product-flow needs for each of the bays.

The engineering of the conveyors also required that the Seller conduct numerous tests of the warehouse's foundation and flooring to ensure that the ground underneath the conveyors remain level. The results of these tests and aforementioned simulations--which included an eight-week analysis in PLACE (where the Seller is based) and another eight-week study in the United States--allowed the Seller to design the conveyors to the precise specifications and needs of AAA.

The Seller's 371-page *Outline Contract & General Conditions and Design Plan* (a portion of which is attached herein as Exhibit A) and approximately 80-120 blueprints evidence the Seller's substantial contribution to the detailed configuration of the conveyors. The design, engineering, fabrication, and installation of the conveyors required that the Seller create for each of the bays between twenty and thirty blueprints outlining their composite layout. The blueprints illustrate the conveyors' floor and ceiling supports--including their angles and elevations--and the placements of their laser eyes, cassettes, audible fault alarms, rail cranes, energy supplies, shelf blocks, protective fences, maintenance doors, carousel stations, weighing and lifting devices, and automatic bundlers, all of which conform to the unique floor plan of AAA's warehouse. The blueprints also convey many precise details which allow the conveyors to conform to the warehouse's structural configuration--namely, cassette lengths and positionings to accommodate different types of products to be stored and transported, distances between doors, locations of various laser eyes, speeds, lengths, ascents, and descents of belts placed at specific points, high voltage rails and their power supplies, and the locations of feeder and takeaway lines. Exhibit B, attached herein, includes three of the blueprints drawn--namely, bay 9 (Installation Plan), bay 7 (Installation Plan), and bay 6 (Foundation Plan).

According to AAA, the Seller's costs incurred for design and engineering services, fabrication labor, and installation represent approximately 85-90 percent of the conveyors' purchase price to AAA, while direct material costs represent approximately 10-15 percent. The seller is not registered as an Illinois retailer, since it makes no retail sales. Rather, the Seller is considered a service provider (serviceperson), as its line of business focuses upon providing engineering and design services to its customers. Further, less than 35 percent of its overall revenues represents its cost of goods sold (i.e., its direct materials costs) to its service customers.

The conveyors' structural design features demonstrate that they are not permanently affixed to the warehouse. In other words, they rest upon leg supports standing approximately three feet off the ground. The legs are connected in turn to base-plate

anchors with holes drilled in them. The anchors are approximately six to eight inches in length. Bolts, screwed into the anchors' holes, are then used to secure the conveyor systems to the floor of the bays. The conveyors may be removed with no damage to the underlying realty as long as the bolts are unfastened and the anchors pulled out. Indeed, AAA's approval of the aforementioned design features evidences its own intention that the conveyors not be considered part of the underlying realty.

It is possible, therefore, that the conveyor system could be dismantled and erected at another warehouse. Practically speaking, however, it would be prohibitively expensive to do so, since another set up would require the entire redesign and reengineering of the conveyors and a series of foundation tests to ensure their stable positioning. In other words, any potential buyer of the conveyors would need to have precisely the same order flow, customer base, warehouse layout, floor plan, production requirements, and a myriad of other identical business concerns in order for AAA's conveyors to have any value for it. In fact, AAA's conveyors would not even be useful at AAA's other warehouses (all located outside Illinois) due to differences in their layout, product flow, and customer requirements. No other business would purchase AAA's conveyors, as it would simply be less expensive and more practical logistically to contract for its own specially-ordered conveyors.

ISSUE

How should AAA treat the conveyors for Illinois sales and use tax purposes?

STATEMENT

AAA is not under audit by the IDOR. To the best of our knowledge, the IDOR has not previously ruled on the same or a similar issue for AAA, nor has AAA submitted a petition on a similar issue and withdrawn it before a letter ruling was issued. The IDOR has written though a General Information Letter (GIL) on this issue. A copy of the GIL is attached.

LAW

Illinois imposes a Retailers' Occupation Tax (the ROT) at a rate of 6.25 percent on persons engaged in selling at retail within the state tangible personal property. 35 ILCS 120/2. A Use Tax (the UT) at a rate of 6.25 percent is imposed upon the privilege of using in the state tangible personal property purchased anywhere at retail. 35 ILCS 105/3; 35 ILCS 105/3-10. Illinois also imposes a Service Occupation Tax (the SOT) at a rate of 6.25 percent on tangible personal property which servicepersons transfer as an incident to making sales of service in the state. 35 ILCS 115/3, 35 ILCS 115/3-10.

When a serviceperson designs, develops, and produces special-order machinery or equipment, taxation under the SOT Act applies and is measured by the cost price to the serviceperson of the tangible personal property transferred to the service customer. 35 ILCS 115/3-10. 'Cost price' means the consideration that the serviceperson pays to its supplier for the tangible personal property that it transfers to its service customer. 35 ILCS 115/2; 86 Ill. Adm. Code Sec. 140.201(a).

Pursuant to an IDOR regulation, special-order machinery is produced when (I) the purchaser employs the seller specifically for its engineering and design skills to produce

a machine to meet the purchaser's particular and unique needs; (2) the machine has use or value only for the specific purpose for which it is produced, and (3) the machine has use or value only to the purchaser. The regulation adds that, in the case of special conveyors, the sale would receive SOT treatment even if a fairly substantial portion of the conveyor were made of standard parts or raw material (such as steel), which could be stocked for sale. 86 Ill. Admin. Code Sec. 130.2115(b) and (c).

Illinois case law addressing conveyors also stipulates three criteria for identifying special-order property subject to treatment under the SOT Act: (1) The seller contributes substantially to the design of the product. (2) The property has use or value only to the purchaser. In other words, the property has to be produced according to special requirements peculiar to the purchaser and not common to others whose conditions for possible use of the property are reasonably comparable to those of the purchaser. (3) The equipment has only salvage value to others and therefore is useless to anyone but the customer for whom it is produced. *Caterpillar Tractor Co. v Department of Revenue (Illinois Supreme Court, 1963)*.

Under the SOT Act, if a serviceperson's ratio of its cost price of tangible personal property transferred to its gross receipts from service sales is below 35 percent, the serviceperson is considered de minimis. A de minimis serviceperson, who is otherwise required to be registered as a retailer, may elect to incur SOT on its cost price of the tangible personal property transferred as an incident to its sales of service. Conversely, a de minimis serviceperson, not required to be registered as a retailer, may elect to incur a UT liability on the cost price to it of the tangible personal property which it transfers to service customers as incidental to making sales of service. The de minimis serviceperson incurring UT liability is considered to be the end user of the tangible personal property transferred to its service customers. In this situation, the de minimis serviceperson's customer does not incur any sales or use tax liability, since the customer is not deemed to be the user of the tangible personal property transferred. Accordingly, the de minimis serviceperson incurring a UT liability is not authorized to collect 'tax' from its service customers. However, the de minimis serviceperson may collect from the customer 'reimbursement' for its own tax liability. If reimbursement is sought and appears as a separate item on the serviceperson's bill, it must clearly be identified as 'reimbursement' for the serviceperson's UT liability and not as a tax upon the service customer. 35 ILCS 115/3-10. 86 Ill. Adm. Code Sec. 140.105, 140.108, and 140.109.

ANALYSIS

AAA's conveyors meet for the following reasons the requirements under Illinois law for designation as special-order property:

- AAA chose the Seller over other business competitors because of the Seller's reputation in the industry as a 'world-wide leader' in the field of designing and engineering conveyors to meet a customer's specific needs.
- The Seller's development of a 371-page sales proposal/design plan--including approximately 80-120 engineering blueprints--and its performance of extensive testing and simulations demonstrate that it created conveyors to fit the rigorously exact and unique specifications required by AAA at its specific warehouse location.

- Emphasis on the Seller's design and engineering skills is underscored by the fact that approximately 85-90 percent of the Seller's production costs were attributable to services--design, engineering, fabrication, and installation--while only 10-15 percent were attributable to direct-material purchases.
- The conveyors have value only to AAA. Even if the conveyors were dismantled and set up elsewhere, the costs so incurred would exceed those attached to purchasing new conveyors. As such, the conveyors have little more than scrap value to any other potential purchaser.
- The conveyors remain tangible personal property after their installation. As they have been only bolted down to the underlying realty, they may be removed without damaging the warehouse. Further, AAA's approval of the Seller's design plan evidences its intention to maintain the conveyors upon their installation as tangible personal property.

Thus, applying state law to the facts in the case, AAA's conveyors should be considered special-order machinery.

Under the SOT Act the Seller is considered for the following reasons to be a de minimis serviceperson which is not otherwise required to be registered as a retailer in the state:

- The seller is in the business of designing and engineering special-order property, not in making sales, at retail.
- The overall cost to it of direct materials used equals less than 35 percent of its overall revenues from making sales of design and engineering services.

Thus, applying state law to the facts in the case, the Seller may incur use tax measured by the cost price to it of the tangible personal property (i.e., the direct materials) transferred to AAA as incidental to providing AAA with the special-order conveyors. The use tax should be calculated by multiplying the direct materials costs by the state use tax rate of 6.25 percent. AAA, as the customer of the de minimis serviceperson, should not in this regard incur any tax liability.

CONTRARY AUTHORITY AND DISCUSSION

No contrary authority has been found.

INFORMATION TO BE WITHHELD

We respectfully request that the IDOR delete AAA's name from the publicly disseminated version of the PLR.

CONCLUSION

Based on the foregoing analysis please confirm that:

- AAA's purchase of the conveyors should be taxed under the SOT Act and be measured by the Seller's cost price of the direct materials transferred to AAA.
- The Seller, as a de minimis serviceperson not otherwise required to be registered as a retailer in the state, should incur use tax measured by the cost price to it of the direct materials transferred to AAA. The use tax should be calculated by multiplying the direct materials costs by the state use tax rate of 6.25 percent.
- As AAA is not considered for state law and IDOR regulatory purposes, the user of the materials conveyed, it should incur no taxability in this transaction.

• We respectfully request that the IDOR send to us on behalf of AAA a PLR addressing the issue presented. Your care in responding to our request is very much appreciated.

DEPARTMENT'S RESPONSE:

Based upon the information contained in your letter and the documents you have provided, we believe that AAA's purchase of the conveyor system described in your letter and the Outline Contract is a purchase of a special order conveyor system under the guidelines of subsection (b) of Section 130.2115. Consistent with the Illinois Supreme Court's decision in Velten & Pulver, Inc. v. Department of Revenue, 29 Ill. 2d 524 (1963), the sale of this special order conveyor system is not considered a sale at retail and is subject to tax under the Service Occupation Tax Act and the Service Use Tax Act rather than the Retailers' Occupation Tax Act or Use Tax Act.

Because the seller of the special order conveyor system is not a party to this letter ruling, we cannot provide a ruling on the seller's Service Occupation Tax or Use Tax liability. However, we can provide you a conditional ruling regarding AAA's Use Tax or Service Use Tax liability, if any, based upon the seller's activities. You stated in your letter that the seller's cost of goods sold represents less than 35% of its overall revenues from sales of service. You have also represented that the seller is not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. Based upon these representations, we believe that AAA incurs no Use Tax or Service Use Tax liability on the purchase of the special order conveyor system.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

I hope this information is helpful. If you have questions regarding this Private Letter Ruling you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, please visit our website at www.revenue.state.il.us or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

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